

M&A Academy

How to anticipate/handle covenant breaches

10 December 2009

Agenda

Introduction: setting the scene

Can the Belgian Continuity Act play a role in this market reality?

The covenant story

Conclusion

Who are we?



Karin Winters leads the Corporate & Commercial Law department of PwC, after having worked in different law firms for more than ten years.

She assisted numerous Belgian and international clients in setting up, (re)structuring and handling their corporate and financial organisation and activities.

She was involved in various international acquisitions and corporate restructurings, including pre- and post-acquisition restructurings, setting up group structures and advising groups during the entire corporate life cycle. Her involvement included the structuring of the transactions, the financing thereof, and providing advice on all aspects of Belgian corporate and commercial law.

Karin holds a law degree of the University of Leuven.

Who are we?



Philippe Fimmers is a Senior Manager in the Deals practice in Belgium.

Over the past 8 years, Philippe has mainly been involved in acquisition and vendor financial due diligences, auction processes and carve-out deals, and this within several industries including services, real estate, production and distribution companies. From his financial due diligence background, Philippe has specialized in independent business reviews and restructuring projects. He has worked for both private equity and corporate clients, and has gained a high level of expertise in the area of due diligence (both buy-side and sell-side).

Philippe holds a master's degree in financial and business management from EHSAL Brussels.

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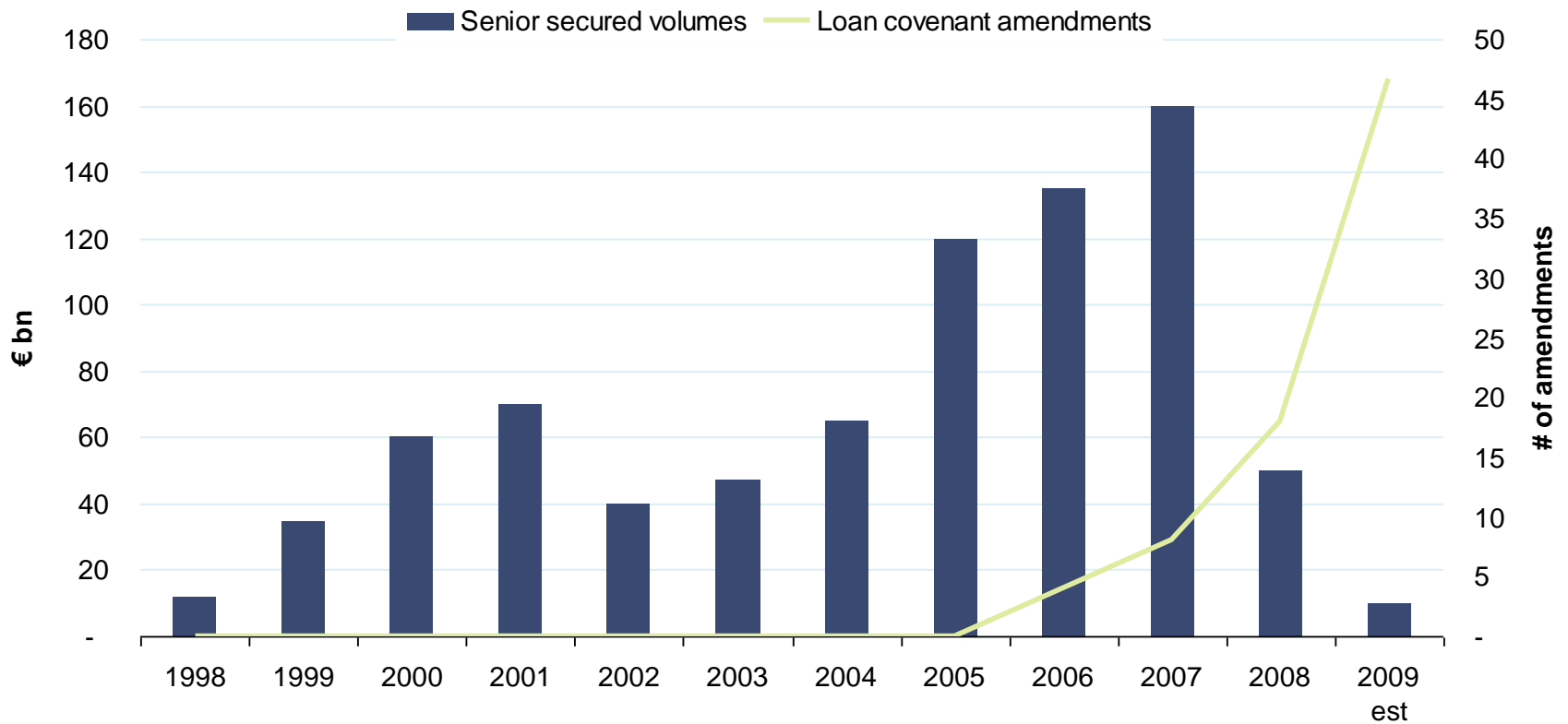
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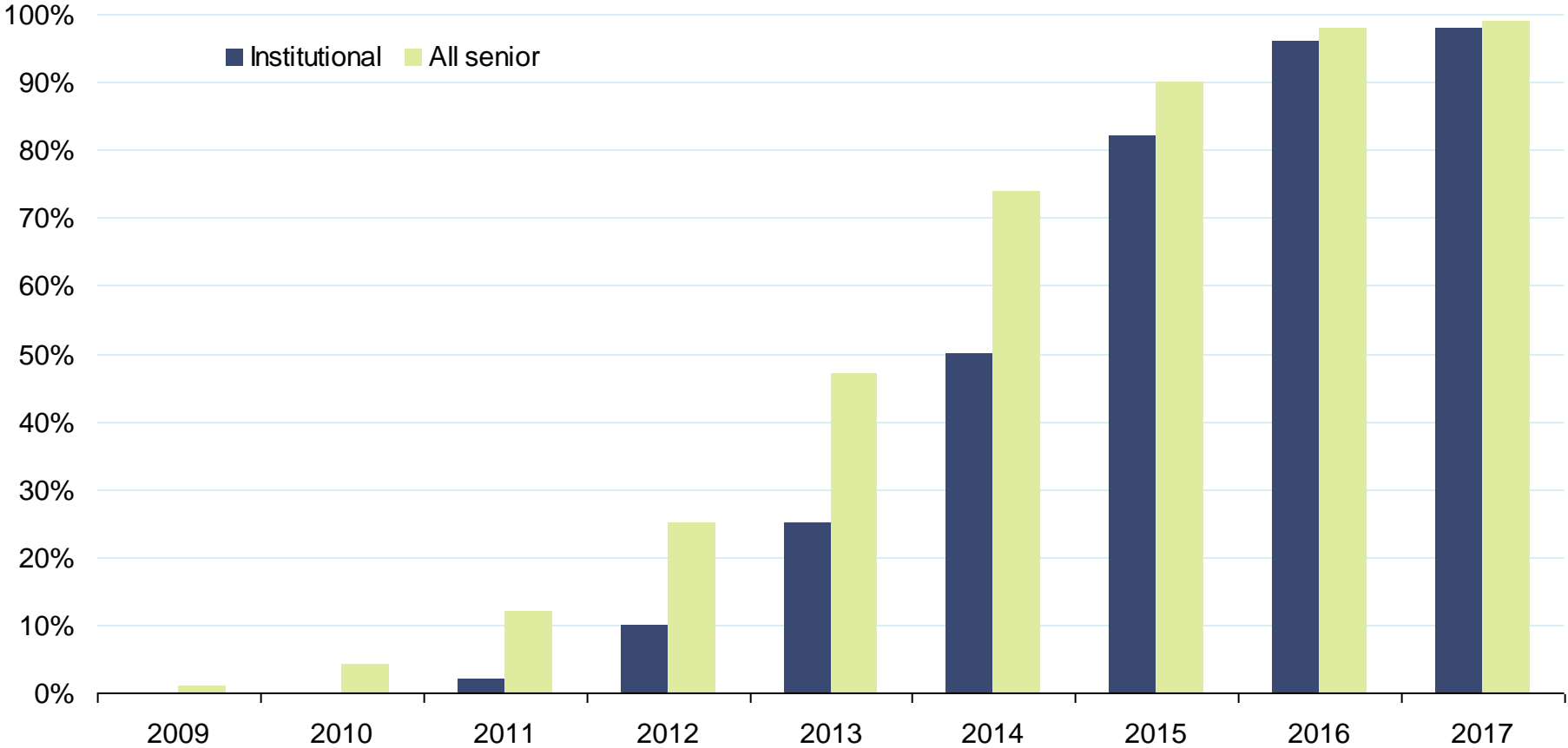
European loan markets have dried up and defaults have risen exponentially. Historical leverage levels will probably not return...

Loan volumes and covenant amendments in Europe



... creating a large refinancing cliff with 70% of debt to be refinanced before 2014.

Estimated senior secured loan maturity profile (cumulative)



Restructuring trends in the current market

Debt-to- equity swaps

- Many debt to equity swaps of leveraged loans
- Debt to equity swaps in public markets are less common

Private equity players are increasingly cutting their losses

- Fewer additional equity injections by private equity due to lower reputational risk, capital constraints and higher opportunity cost of capital

Higher cost of covenant resets and higher pricing

- Fees related to resetting covenants have increased to 50 -100bps
- Higher interest margins are demanded by lenders
- Equity injections are often required

Role of management increasingly difficult

- Change in balance of power
- Few management teams have restructuring experience
- Equity is 'under water'

Increased demand for independent business reviews

- A significant pick-up of IBRs in the last ten months
- Common 'independent' information set is increasingly required

Behaviour of the banks

- **New shareholders**
- **Changed approach to risk management**
 - Existing clients
 - Material business
 - Higher margins
 - Borrowing base approach

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Belgian Continuity Act of 31 January 2009

Introduction

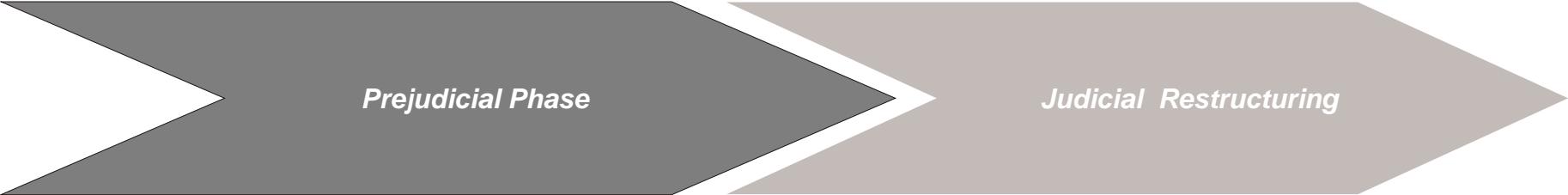
Background

- Economic downturn – increase of bankruptcies
- Failure of insolvency legislation: the judicial composition (“*gerechtelijke akkoord*” / “*concordat judiciaire*”) does not work.

Purpose: Sustain continuity of business as much as economically possible through:

- Enhanced accessibility
- Enhanced flexibility
- Enhanced autonomy

Belgian Continuity Act: overview of reorganization cycle



- Collection of data**
- Collection of data & info
 - Follow up by Chambers of Commercial Enquiries
 - Hearing of debtor

- Mediator of enterprises**
- Upon request of debtor
 - Assist debtor with reorganization and negotiations

- Amicable agreement**
- If filed, special protection in event of bankruptcy
 - Confidential

- Collective agreement**
- Restructuring plan to be ratified by court
 - Approval of majority of creditors
 - Agent of justice (upon request debtor)

- Transfer under judicial supervision**
- Transfer of all or part of business
 - Agent of justice (automatically)

- Amicable agreement**
- If acknowledged by court, special protection in event of bankruptcy
 - Agent of justice (upon request debtor)

Prejudicial Phase



Collection of data

- **Collection / update of data & information** relating to financial situation of enterprises at clerk's office of Commercial Court
- **Chambers of Commercial Enquiries** monitor and follow up on situation
- When enterprise's business is considered to be **threatened**:
 - Hearing of debtor
 - Right of debtor to access file & correct data

Mediator of enterprises

- Appointed by Commercial Court
- **Upon request of debtor**
- **Mission:**
 - Assist debtor in reorganization of business
 - Help debtor in negotiations with creditors

Amicable agreement

- **Individual amicable agreement**
- Negotiated by debtor with **at least 2 creditors**
- **No court intervention**, but debtor may request intervention of mediator of enterprises
- If **filed** at clerk's office →
 - Binding
 - Special protection mechanism in case of bankruptcy
- Remains confidential

Judicial restructuring



Why?

- To preserve the continuity of all or part of debtor's ailing enterprise

When?

- Upon demonstration that continuity of business is threatened
- Presumption if net assets $\frac{1}{2}$ share capital due to losses
- Still possible if bankruptcy conditions are **met (new!)**

Effects

- Suspension period (max 6m – extendable up to 18m)
 - No bankruptcy
 - No judicial dissolution
 - No enforcement measures
 - No termination of contracts due to ongoing judicial restructuring
 - Penalty clauses without effect
- Appointment of delegated judge
- Publication of judicial decision in Belgian Official Gazette
- Individual information of all creditors by debtor

Judicial restructuring

“Portal” of measures



Amicable agreement

- **Individual agreement** with at least 2 creditors
- No limitation on content
- Debtor may request appointment of **Agent of Justice** to assist in restructuring / negotiations
- **Acknowledgement** by court by means of judgement
- **Binding**
- **Special protection** mechanism in event of bankruptcy
- **Special tax and VAT regime** in case of debt reduction

Collective agreement

- Debtor seeks approval of creditors for **restructuring plan**
- Subject to approval of **majority of creditors representing ½ sums due** as principal amount
- Maximum duration of **5 years**
- Debtor may request appointment of **Agent of Justice**
- **Ratified** by Court by means of judgement
- **Binding**
- **Special tax and VAT regime** in case of debt reduction

Transfer

- **Transfer under judicial supervision** of all or part of debtor's business
- At **request** of
 - Debtor
 - Prosecutor / Creditor / Interested buyer under certain circumstances
- Automatic appointment of **Agent of Justice**
- **Order of transfer by court** after examination of reports by delegated judge
- Organization and realization of transfer **by Agent of Justice in name and on behalf of debtor**
- **Favourable social regime**: no automatic transfer of all employees, no joint and several liability
- **Special VAT regime**

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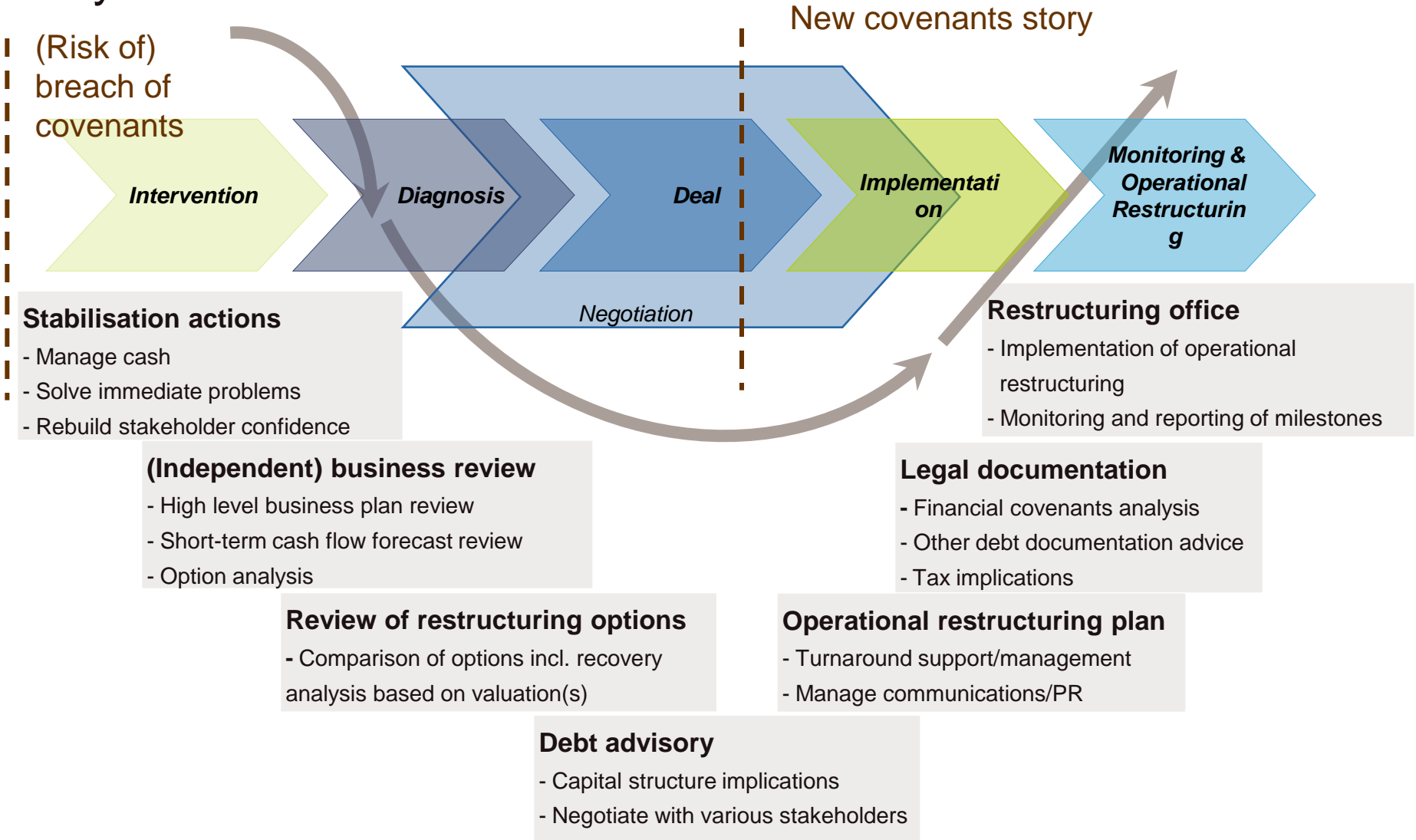
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How does the Belgian continuity act link with the Covenant story?



Covenants

- 1) What are covenants?
- 2) Different kinds of covenants
- 3) Breach of covenants: possible (legal) consequences
- 4) Best practice approach to set covenants
- 5) Lessons learned

1) What are covenants

Covenants are contractual clauses in lending facilities that outline what a borrower must affirmatively do during the term of the loan (affirmative covenants) or may not do (negative covenants)

- For the company
 - “Keurslijf” (Rules of the Game)
- For the banks
 - Early warning system
 - Control
 - Cash sweeps
 - Price/return/risk
 - Additional fees

2) Different types of covenants

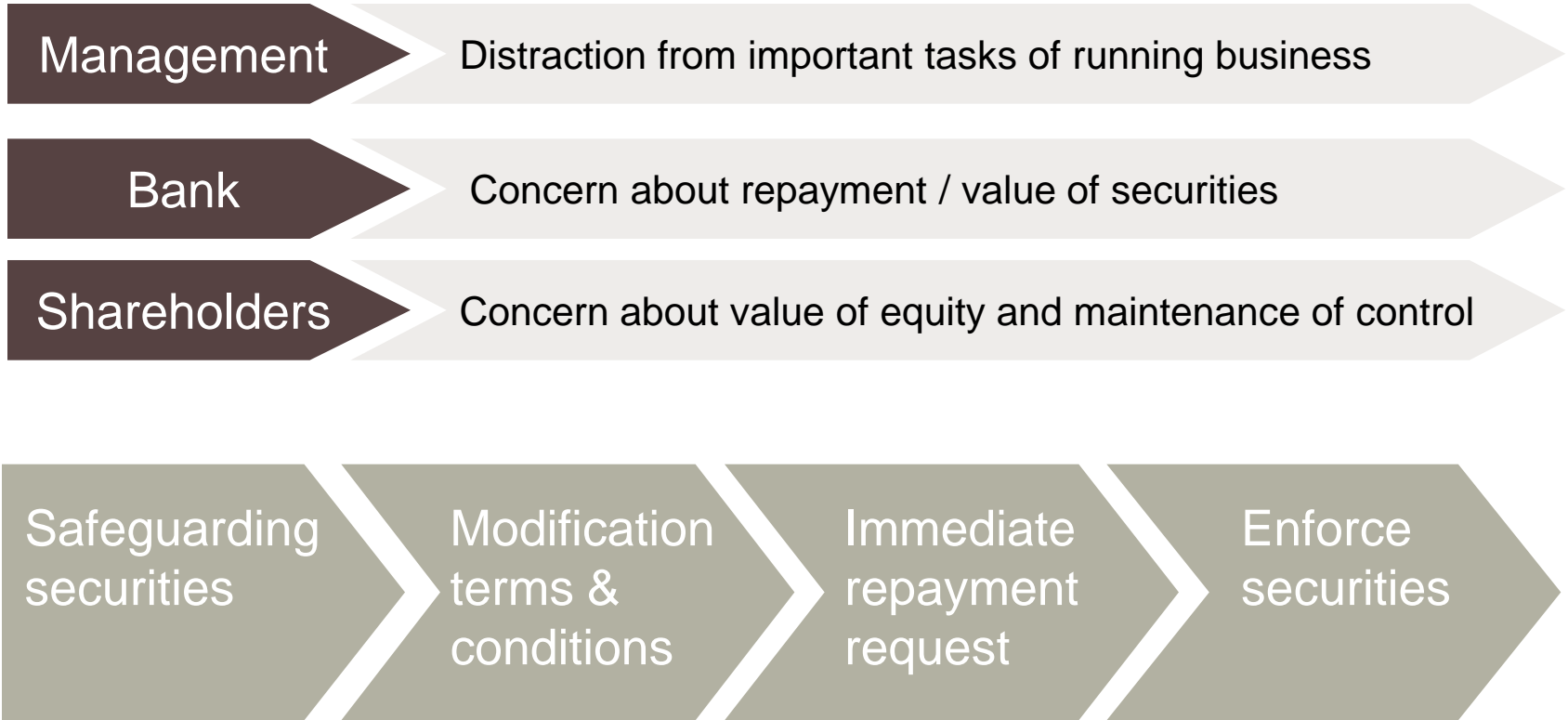
Financial Covenants

- Ratio net borrowings / EBITDA
- Ratio EBITDA / interest expense
- Ratio debt / equity
- Current ratio
- Net income
- Net worth
- Capex limit
- ...

Non Financial Covenants

- No dividends
- No share buy-backs
- No additional debt or liens
- Limitation new investments
- Ordinary course conduct of business
- Pay taxes
- Maintain condition of assets + insurance
- No change of nature of business
- Insurance
- Legal validity
- Environmental
- No mergers and acquisitions
- ...

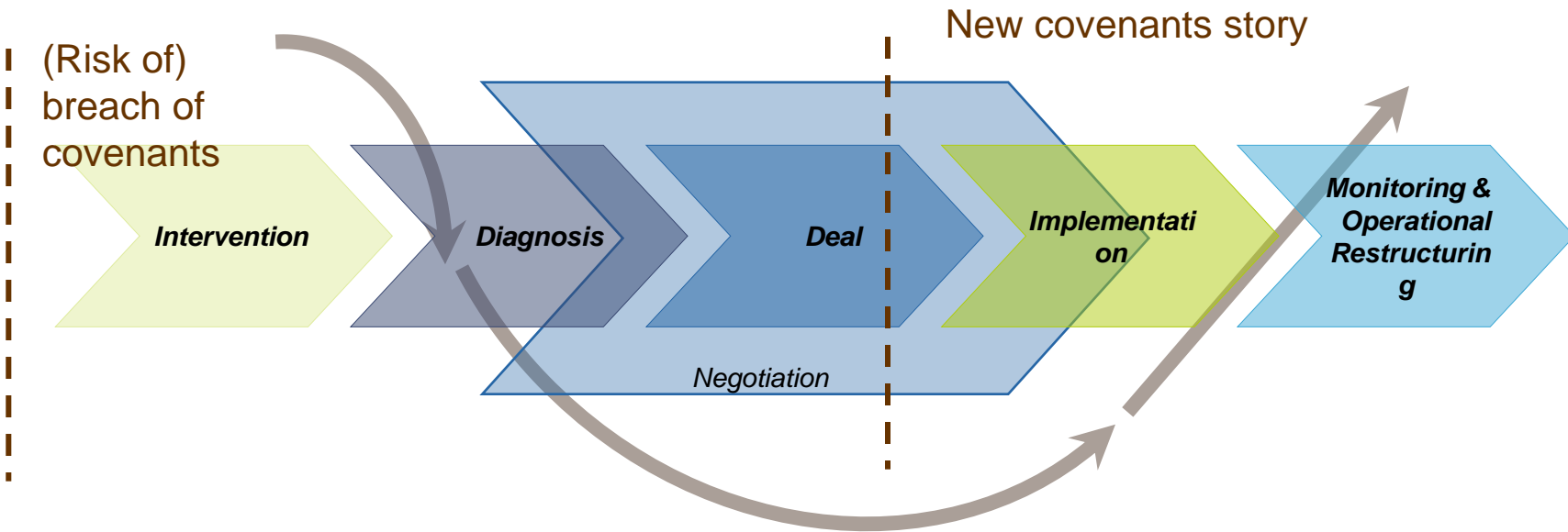
3) Breach of covenants: possible (legal) consequences



4) Best practice approach

- Balance between company's and banks interests
- Adequate financial structure
- Capacity to generate future free cash flow : Starting point
 - Market position;
 - Operational excellence;
 - Your cash flows.

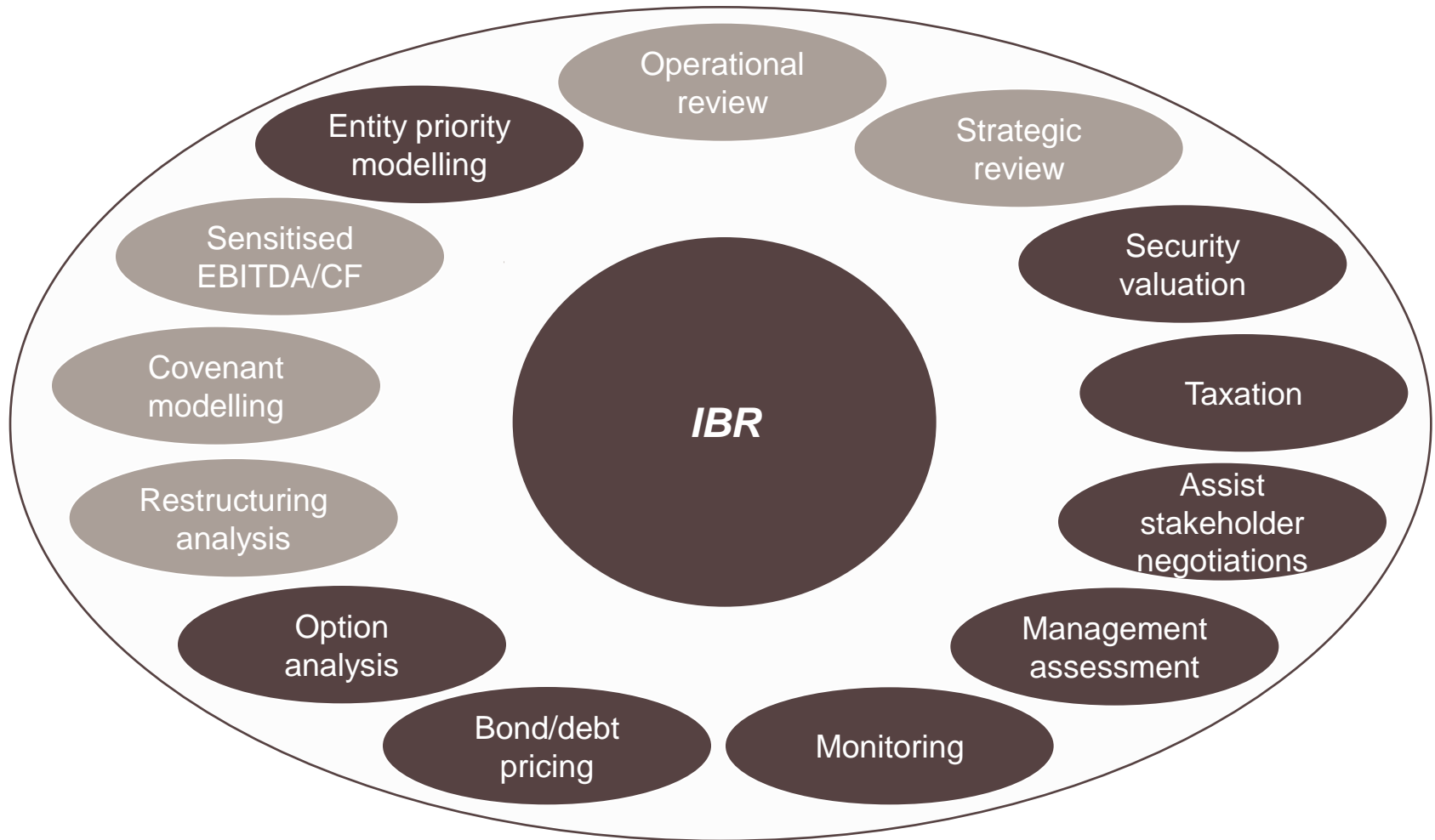
Capacity to generate future free cash flow: Starting point



(Independent) business review

- High level business plan review
- Short-term cash flow forecast review
- Option analysis

An IBR forms the common information platform which is the basis of a restructuring...



5) Lessons learned

- **Starting point for financial covenants is often the sensitised case as defined in the IBR**
 - **Setting of financial covenants in a restructuring is time consuming**
 - Business plan will continuously be updated to reflect movements in working capital, restructuring costs, amount of equity etc.
 - **Trade-off between the amount of equity invested and the covenant headroom**
 - **Issues to consider when setting covenants**
 - Grace period in testing covenants – cash in company should always be tested
 - How do you set covenants with a negative EBITDA?
 - LTM EBITDA >0 at a certain point in time
 - Alternatives: Net worth, cash balance test, KPI's...
 - Headroom on sensitised case is generally relatively small compared to a leverage finance transaction (ca. 5%-10% vs. 20-25%)
 - Exceptional items need to be defined as explicitly as possible
- (Recurring EBITDA versus EBITDA)**
- **Non-financial covenants relating to restructuring milestones** should be considered
-
- **A link between financial covenants calculations and management accounts needs to be made in order to avoid manipulation**

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- The Business Continuity Act does **not** take into account **all steps** of the real life restructuring lifecycle.
- Business Continuity Act **may be interesting** in some cases:
 - Suspension period => gain time
 - Favourable tax and VAT regime in case of reduction of debt in frame of judicial reorganization
 - Favourable social regime in case of transfer of business under judicial supervision
- Business Continuity Act is mainly **debtor-driven** (e.g. no right of initiative for lender to request appointment of Agent of Justice or Mediator of enterprises).

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